TESTIMONY OF PAUL S. HEWITT

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ON S. 1527, THE CIVIL SERVICE PENSION REFORM ACT

BEFORE THE SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

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My name is Paul Hewitt, and I am the President and Executive Director of Americans for Generational Equity. I appreciate this opportunity to testify before the Governmental Affairs Committee on the Civil Service Pension Reform Act, a bill with major long-term consequences for the economy. Accompanying me is Phillip Longman, AGE's Director of Research.

Americans for Generational Equity was recently formed under the bipartisan leadership of Senator Dave Durenberger and Representative James R. Jones to speak out on issues affecting the economic prospects of younger and future generations of Americans.

Our concern is that many of the policies and decisions made today have ramifications far into the future. But, invariably, the young people who are most affected by them go largely unrepresented in the policy making process. The legislation now before this Committee is an excellent case in point. The vast majority of those whose future benefits are being established through the Committee's efforts will have little say in their definition.

Similarly, the future taxpayers who ultimately will be called upon to finance these benefits are also unrepresented.

I am here today primarily to speak for the second of these two groups. While I will touch upon issues of special interest to future civil service retirees, my principal goal is to provide an assessment of the long-term public interest in the design of this and other government retirement programs, and to frame the Committee's efforts in the broadest possible perspective.

Principles

Mr. Chairman, I would like to begin by outlining two basic principles that I believe should guide the design of a new Civil Service Retirement System: (1) minimizing the system's unfunded liabilities; and (2) efficiently attracting and retaining competent employees.

1. Minimize the Creation of New Unfunded Liabilities.

The first, and most important principle is that new unfunded liabilities under the Civil Service Retirement System should be minimized. As the Chairman has observed many times in the past, creating an unfunded liability is tantamount to expanding the national debt.

In fact, the only real distinction between adding to CSRS' unfunded liability and increasing the national debt is that the Constitution obliges future congresses to honor the nation's debts; whereas, it prevents the promises of this congress from binding future congresses. However, assuming that future taxpayers do keep today's promises to future retirees, both unfunded liabilities and the national debt comprise money that must come out of the pockets of future taxpayers. Accordingly, both should be viewed with an equal degree of caution.

While the issue of federal borrowing crowds the nation's headlines, few realize that the unfunded liability of the CSRS trust fund alone is equal to almost a third of the official national debt. The Office of Personnel Management estimated last year that the system's unfunded liability as of September 30, 1984, was $542 billion. Its rate of increase -- $13 billion in the year since September 30, 1983 -- had slowed from prior years, because federal workers hired after December 31, 1983 were not covered under CSRS. However, when Congress defines the entitlements of these new workers, the unfunded liability will jump significantly. The only question is by how much.

In deciding this question, the Committee should consider the fact that future taxpayers may not be able to keep our promises. In the early 1960's, when CSRS was last overhauled, Americans were very optimistic about the income prospects of future taxpayers.

That in large part explains why we now have such a generous federal retirement system. But today, we have every reason to be prudent in assessing future taxpayers' prospects.

Consider that we are leaving today's children with a national debt that, after adjusting for inflation, is ten times the amount that existed following World War II. Working with the Congressional Research Service, Representative John Porter recently estimated that a person entering the workforce in 1990 will pay an average of $100,000 in taxes over his or her lifetime to service the interest on the national debt--a conservative estimate that assumes only 6 percent interest rates and no further growth in the debt. Similarly, we estimate that today's average young workers each stand to pay an extra $10,000 in taxes over their lives to service the interest on just this year's deficit.

Consider also that future taxpayers will have to pay off the gigantic unfunded liability of the Social Security system, which totals almost three and one-half times the national debt. Although Social Security is supposed to be accumulating a surplus that will finance the Baby Boom generation's retirement, the money is not going to be there. The Treasury is borrowing it to meet current expenses, leaving only IOU's between future taxpayers and future retirees. As a result, future workers -- whose ratio to the the retired population will be much lower than it is now -- must foot the full bill for the Baby Boom's Social Security and Medicare benefits--most likely through a series of large tax increases, beginning about 2020 under optimistic actuarial assumptions.

Mr. Chairman, unlike the 1960's, the current trend in personal income is downward; upward mobility is no longer a general phenomenon. Since 1972, the incomes of U.S. workers have declined across the board. But the drop has been greatest among the young, who will inherit today's unfunded liabilities. Between 1973 and 1983, for example, the real, after-tax incomes of households headed by persons age 25-34 declined almost 19 percent.

Finally, an examination of the poverty rate among today's young children suggests that the trend toward downward mobility is only beginning. Demographers estimate that one in three children born this year will experience poverty at some time before reaching the age of 18. Because poor youths tend to become poor adults, we can anticipate that a very large underclass will compete for the tax dollars of working Americans well into the next century. At the very least, we can expect that many future taxpayers will not be wealthy enough to afford the high tax rates needed to pay the nation's rapidly accumulating bills.

The upshot, Mr. Chairman, is that the consciencious development of federal pension policy must anticipate the distinct possibility that future taxpayers will either be unable, or unwilling to support large unfunded federal pension liabilities.

Indeed, the bigger the unfunded liabilities we create, the greater is the liklihood that our promises will be broken. Clearly, such apparent generosity would be neither compassionate to civil servants nor consistent with the long-term public interest.

2. Efficiently Attract and Retain Competent Employees.

My second principle relates to the efficient accomplishment of a basic CSRS goal: to attract and retain competent employees. The current federal compensation structure is a failure in this regard, and current retirement policies are part of the problem. Today's high retirement benefits are neither the best, nor the most economical means of accomplishing this goal.

To prove my point, I would refer you to the testimony of the many public employee groups who are objecting to S. 1527's Thrift Savings plan on the grounds that many employees will not take full advantage of it. They know that employees prefer pay today to future retirement benefits. Indeed, experience tells us that the best way to attract highly qualified employees is through high pay, not retirement benefits.

Yet, for obvious reasons, Congress has a clear preference for paying later, rather than now. For one thing, future taxpayers are much more compliant than present ones. For another, unfunded liabilities will not show up on this year's budget. As a consequence, the government has saddled itself with a compensation structure that is increasingly skewed toward "deferred compensation."

While studies consistently show that total federal compensation -- including pay, health benefits and retirement -- is roughly on par with that provided by large private sector firms, they also show that pay tends to be significantly lower, while retirement benefits compensate by being significantly higher. Under this structure, however, federal compensation policy is geared less toward attracting good employees than retaining the ones we have. It is discomforting to note that the employees who are being retained are those we have attracted with substandard pay; they are probably not the best available.

The legacy of such an approach is chilling. Mr. Chairman, we are systematically creating a less efficient, less creative, and less motivated workforce to carry out federal programs. And the consequence for America's future is that there will be more heavy-handed regulation, more $9,000 allen wrenches, and fewer imaginative solutions to the many challenges facing government.

In short, I would conclude that the current federal compensation policy does a double injustice to future taxpayers. Not only does it contemplate that they will pay the lion's share of the cost of compensating today's civil servants through "deferred compensation." It guarantees that they will be served by a less-qualified workforce than could have been recruited had today's taxpayers been willing to shoulder their fair share of the compensation burden.

Analysis of Legislation

In analyzing the Civil Service Pension Reform Act (S. 1527), one is tempted to say that the glass is half-empty. Clearly, the bill is a long way from accommodating the principles of generational equity. Yet, compared with the current retirement system, this legislation represents a major step in the direction of intergenerational fairness and fiscal responsibility.

I recognize that the provisions in S. 1527 that I consider the most desirable are controversial among the powerful special interest groups who would have us replicate the current CSRS in order to justify the unrealistic promises made to current employees. I also recognize that these provisions compete with the important short-term goals of deficit reduction and avoiding unnecessary tax increases. For this, I commend the bill's sponsors for their courage and foresight.

The principal innovation of S. 1527 is its Thrift Savings plan, under subchapter III. This plan envisions that up to 22 percent of the employer's total retirement contributions will be placed in employee-owned accounts in the private sector, when matched by a like amount of employee savings. By so doing, the federal government would be funding a substantial portion of its pension liabilities in advance. The effect would be to move away from the current system of financing all retirement benefits with unfunded liabilities, which are nothing more than IOU's from future taxpayers to future retirees. This approach is much fairer to future taxpayers.

In addition, by encouraging employee saving, the plan would stimulate capital formation and investment in the world competitive technologies that future workers will require, if they are to finance the Baby Boom generation's retirement.

S. 1527 envisions the full advance funding of the Thrift Savings plan but plans to phase it in over a ten-year period. Such a transition may well be necessary in light of the federal government's need to get its fiscal house in order in the meantime. Advance funding means that today's taxpayers must shoulder a greater share of the burden for the retirement of today's civil servants. This costs money, and at a time when deficits threaten to precipitate an economic crisis, it is understandable that Congress would want to avoid actions that increase short-term pressures on the budget.

Mr. Chairman, in concluding, I would point out that with a normal cost of 20.8 percent of payroll, the pension plan envisioned under S. 1527 achieves only a modest 16.8 percent savings, compared to the current plan. This is still about 2 percent of payroll higher than the better private sector plans. And until federal pension costs get down to the levels provided by the private sector, it is unrealistic to discuss the meaningful kinds of federal pay reform that will be necessary to enable government to compete with private firms for the best talent available.

Finally, I would note that about 72 percent of the savings under this plan would come from the cost-of-living allowance formula, which envisions that COLA's would be two percentage points less than increases in the consumer price index. While such a policy is more or less consistent with private sector practice, it has practical political drawbacks. The public employee unions and retiree associations will fight any such change out of fear that the new COLA formula will next be applied to them. I would recommend, therefore, that the Committee look for savings in other areas, such as reducing the accrual rate under the defined benefit portion of the plan, or raising the federal retirement age to more closely match that under the Social Security program.

Although changes to the bill are in order, it is overall a good effort. Clearly, S. 1527 could do much more to improve the intergenerational fairness of federal retirement policy. But I suspect it is close to the best that can be accomplished this year under existing constraints. For that, the bill's sponsors deserve great credit.

That concludes my comments, Mr. Chairman. Phil Longman and I will be happy to answer any questions the Committee may have.